No. ——

In the

Supreme Court of the United States

October Term, 1942

AMERICAN LIBERTY OIL COMPANY, *Petitioner,*

vs.

COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

BRIEF IN SUPPORT OF PETITION

OPINIONS BELOW

The findings and opinion of the United States Board of Tax Appeals are reported *American Liberty Oil Company vs. Commissioner*, 43 B.T.A. 76. The opinion and judgment of the Circuit Court of Appeals for the Fifth Circuit was rendered April 3, 1942 and reported in 127 Fed. (2d) 262.

JURISDICTION

The right of review of a decision of the Circuit Court of Appeals of the United States and the statutes applicable

thereto are fully set forth in rule 38 of the revised rules of this Honorable Court and no further reference need be made.

STATEMENT OF FACTS

The controlling facts are stated in the foregoing petition.

SPECIFICATIONS OF ERROR

The Board of Tax Appeals and the Circuit Court of Appeals for the Fifth Circuit has erred in the following particulars.

1. In denying the petitioner a full return of its leasehold cost in computing the gain from the sale of the leases to Atlantic Oil Producing Company.

2. In holding that any part of petitioners leasehold cost should be allocated to its right to recover 4,400,000 barrels of oil reserved *when, as and if produced.*

3. In the alternative, if any portion of the leasehold cost should be allocated to the oil reservation that such allocation should be made on a barrel basis.

4. In failing to hold that the amount paid the Tyler Pipe Line Company did not constitute a part of the cost of the sale made to the Atlantic Oil Producing Company.

ARGUMENT

Point One

The petitioner should have a full return of its leasehold cost.

After allowing the petitioner a full return of its equipment cost, both the Board and the Circuit Court of Appeals for the Fifth Circuit held that petitioners leasehold cost must be allocated between the oil interest sold and the oil interest reserved on the basis of relative values at the time of the sale.

The principle that we seek to urge is that a tax payer is always first entitled to a return of its capital investment. In this particular case the facts are that the tax-payer (petitioner) received $1,500,000 in cash, whereas, it had expended on the property sold more than $1,614,000.

Whether petitioner would ever recover its entire capital investment was based on mere conjecture because its right to receive anymore from its investment was predicated upon whether or not the 4,400,000 barrels of oil reserved would ever be produced.

We think that this Court in the case of *Burnet vs. Logan*, 283 U. S. 404 has established the correct rule of law. In that case the tax-payer sold certain stock, received a cash payment therefor, and the right to receive royalty of so much per ton on certain iron ore, which might or might not be produced. The then Commissioner of Internal Revenue

attempted to tax the taxpayer on the basis of the value of the right to receive the ore. When the case reached this Honorable Court it held "the consideration for the sale was $2,200,000 in cash and the promise of future money payments wholly contingent upon facts and circumstances not possible to foretell with anything like fair certainty * * * "She properly demanded the return of her capital investment before assessment of any taxable profit based on conjecture."

It is submitted that this decision of this Court is controlling. In our case, as in the case cited, petitioner could recoup its cost only provided the 4,400,000 barrels of oil were produced.

We therefore submit that the action of respondent in allocating a portion of the leasehold cost to the oil reservation was a tax imposed on capital rather than income.

POINT TWO

Where, especially in a case such as this (in which the oil reservation was a reservation of so many barrels of oil in place), if there should be any allocation of leasehold costs to the oil sold, such allocation should be made on a barrel basis and on the ratio that the amount of oil sold bore to the amount of oil reserved.

As the Court will notice, this reservation is an unusual one. It is not an ordinary oil payment in the sense that the

seller reserves so much oil until so much money is realized out of the oil reservation. It is a reservation of 4,400,000 barrels of oil *in place*. (R. 159).

The question then arises how much oil in place did it part with? The question is answered by referring to respondent's own estimate of the amount of recoverable oil in place. According to respondent's estimate, there were 19,089,603 barrels of oil in place when the sale was made. It follows, therefore, that the petitioner sold 14,689,603 barrels of oil in place.

Since in this case the thing retained was not so many dollars payable out of oil but so many barrels of oil in place, it seems that the only proper method of allocating leasehold cost would be on the basis of ratio as the amount of oil reserved bore to the amount of oil sold. *So many barrels of oil in place were sold. So many barrels of oil in place were reserved.*

It is true that this oil reserved would be lifted by the purchaser without cost to the seller, but this added, we submit, not one iota of value to the oil reserved *while it was in place*. It would only increase the profit of the seller when and if the oil was lifted and delivered to him.

This method of allocation was used by the Board in the case of *Ortiz Oil Co. v. Com.*, 37 B. T. A. 656, although in that case the oil reservation was a cash reservation.

It is true that the Board adopted a different method of allocation in the Columbia Oil & Gas Company case, (41

BTA 38) but in so doing, held only that the basis adopted in such case seemed an equitable allocation in that particular case and took pains to say that an equitable allocation would depend upon the facts of each particular case. It is true also that in discussing the Ortiz Oil Company case (37 BTA 656) the Board pointed out that the use of the barrels of oil method in allocating the cost basis was not in dispute. In other words the Respondent concurred.

But, in the case of *E. F. Simms vs. Com.*, 28 B. T. A. 988, where a controversy concerning a proper allocation in connection with a settlement under Rule 50 had raged for a considerable time, the Board made the allocation on a barrel basis, and its memo in connection with such hearing sustained the Respondent saying:

> "We sustain the respondent's method of computation on the right reserved to receive delivery of 400,000 barrels of oil."

It is true that in the Simms case the question was primarily one of depletion, but the method applied there is equally applicable, we submit, to a case of allocation of cost, and we desire to point out that in the Simms case as in this case the reservation was of *so many barrels of oil and not of dollars.*

The Board in the Columbia Gas Company Case (41 BTA 38) points out that respondent's regulation prescribed simply that, "the cost or other basis shall be equitably apportioned," and says that one method of allocating cost be-

tween real estate sold and real estate retained, both being parts of the same tract, is by apportioning the cost in proportion to the respective values of the part sold and the part reserved.

But such method is not always followed. In fact, in the case of *Montrose Cemetery Company v. Com.*, in a memorandum opinion and decision which was affirmed in 105 Fed. 2d 238, involving the ascertainment of the March 1, 1913 value of certain cemetery lots, the Board at great pains ascertained the value on a footage basis, and in determining profit and loss fixed a value of 23c per square foot, although a large tract was involved, and there was a variance in the value of the burial plots.

Certainly, we submit, if such a means of allocation is deemed equitable in a case such as the Montrose Cemetery Company case, a barrel basis is an equitable apportionment or allocation here. So many barrels of oil in place were sold. So many barrels of oil in place were reserved. We urge in this case that any allocation of leasehold cost be on the basis for which we contend.

POINT THREE

The amount paid as damages to the Tyler Pipe Line Company was in every sense a part of the cost of the sale made by American Liberty Oil Company to the Atlantic Oil Producing Company.

The evidence is that at the time of the sale by American Liberty Oil Company to Atlantic Oil Producing Company there was outstanding a contract between the American Liberty Oil Company and the Tyler Pipe Line Company which gave the Tyler Company the exclusive right to run all of the oil from the East Texas properties owned by American Liberty Oil Company.

The evidence is also without dispute that the Atlantic Company would not go through with the purchase of the East Texas properties of American Company unless it could obtain possession of the runs from these properties.

The evidence also is that Mr. Golding, now deceased and the owner of 45% of the stock of American Company, owned no stock in the Tyler Company. C. W. Murchison, also the owner of 45% of the stock of American Liberty Oil Company, had a substantial stock interest in the Tyler Company.

There is no evidence whatsoever which tends to show that the petitioner did not recognize when it made the sale to the Atlantic that by making such sale it was breaching its contract and would be liable at law for damages as the result of such breach or repudiation.

The record reflects the fact that there was considerable bad feeling about the transaction. Golding, who owned no interest in the Tyler Company was anxious to free the American Company of this contract as cheaply as pos-

sible. Frank Murchison, on the contrary, felt that the contract virtually gave him an equity in the property.

There is not a scintilla of evidence which reflects otherwise than that the American Liberty Oil Company at all times admitted the liability and the only dispute was as to the amount of the liability.

The Board of Tax Appeals in denying petitioner the amount paid in 1936, seems to base its opinion on an insufficiency of evidence to show that there was an admitted liability. (R. 68) The Circuit Court of Appeals in its opinion emphasized the fact that petitioner operated on an accrual basis of accounting and yet accrued nothing on its books until 1936.

It is submitted that both the Board and the Circuit Court are clearly in error. Viewed from its four corners, the record, we submit, clearly shows that *there was at all times an admitted liability* and the only dispute existing between petitioner and the Tyler Company was the amount of the liability.

Since petitioner was on an accrual basis and since this liability had to be discharged in order for the sale to be consummated, it is our point that the deduction should have been allowed in the year 1934, the year in which the liability accrued.

CONCLUSION

It is therefore respectfully submitted that this case is one calling for the exercise by this Court of its supervisory powers and to that end a writ of certiorari should issue, and this Court should review the decision of the United States Circuit Court of Appeals for the Fifth Circuit and should reverse it.

Respectfully submitted,

JOHN BARRE KING,
Counsel for Petitioner.